

No. 16823

In the United States Court of Appeals
for the Ninth Circuit

ESTATE OF WALTER F. RAU, SR., DECEASED, RAYMOND
J. SHORB, ADMINISTRATOR WITH THE WILL AN-
NEXED, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT
OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 46-68) have not been officially reported.

JURISDICTION

This petition for review (R. 89-91) involves deficiencies in income taxes and the 50 percent fraud penalty for each of the years 1942 through 1947, inclusive. On January 17, 1956, the Commissioner of Internal Revenue mailed to petitioner on review a statutory notice of deficiency in income taxes aggregating \$148,785.22 and penalties aggregating \$83,255.47. (R. 9.) Within ninety days thereafter, or

on March 20, 1956, a petition was filed with the Tax Court for a redetermination of the deficiencies under the provisions of Section 6213 of the Internal Revenue Code of 1954. (R. 3, 6-9.) By amended answer (R. 41-43), the Commissioner claimed additional deficiencies for the years 1943 through 1946, inclusive, aggregating \$39,895.12 in tax and \$19,947.57 in additions to tax for fraud (R. 46). The decision of the Tax Court was entered September 25, 1959. (R. 88.) The case is brought to this Court by a petition for review filed December 23, 1959. (R. 89-91.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTIONS PRESENTED

1. Whether the Tax Court upon the record was justified in upholding in principal part the Commissioner's determination of deficiencies in income tax for the taxable years involved.

2. Whether the Commissioner was bound to rely upon the net worth method in determining the income of decedent for each of the years under review or whether he was entitled to determine decedent's income by the use of specific omissions from the income returned which were clearly established.

3. Whether the Commissioner fully sustained his burden of proving that a part of the deficiency for each of the taxable years was due to fraud with intent to evade tax, thereby sustaining the 50 percent addition to tax and lifting the bar of the statute of limitations as to the years 1942-1944.

4. Whether the addition to tax pursuant to Section 293(b) of the Internal Revenue Code of 1939 for each

of the years involved survives the death of the taxpayer.¹

STATUTES AND RULE INVOLVED

These may be found in the Appendix, *infra*.

STATEMENT

The findings of fact of the Tax Court (R. 47-64), based partially upon stipulated facts and exhibits which were incorporated in the findings by reference, may be summarized as follows:

Taxpayer, Walter F. Rau, Sr., who was declared incompetent by court order on May 12, 1952, died on January 4, 1953, when approximately 78 years of age. On March 9, 1955, Raymond J. Shorb was appointed as administrator with the will attached. At the time of his death, the taxpayer, hereinafter referred to as the decedent, was a widower, his wife having died on December 27, 1942. He filed a separate return for 1942 on a community property basis. His individual returns for all the taxable years were filed with the Collector of Internal Revenue at Los Angeles, California. (R. 47.)

Commencing in 1932, and continuing to August 7, 1947, decedent, as sole proprietor, operated a business known as the Southern Hotel in Bakersfield, California. In addition, he owned and operated the French Cafe and the Southern Wine and Liquor Store (hereinafter sometimes referred to as the Southern

¹The petitioner failed to raise this issue in his pleadings below and first made reference to it in his brief. Although this issue will be considered in this brief, we submit that it was improperly raised (R. 68) and is therefore not properly before this Court on appeal.

Bar or the Southern Wine and Liquor Bar), located in the Southern Hotel. The French Cafe was operated as a sole proprietorship from 1934 until May 6, 1946, at which time decedent formed a partnership with one Phil Bender to operate that business. This partnership was terminated on August 16, 1947. On June 1, 1947, an equal partnership consisting of decedent, Phil Bender, and Robert R. Webb, manager of the Southern Hotel and employed by decedent since 1932, was formed for the purpose of conducting a business also known as the French Cafe in the vicinity of the Southern Hotel. This business continued in operation through 1947. The Southern Bar was owned and operated solely by decedent from 1934 to August 12, 1947. (R. 47-49.) Beginning in 1944, and continuing through the years in question, decedent owned and operated the Edmund and Sea Spray Hotels in Venice, California. In June, 1946, decedent purchased the Taft Hotel in Taft, California, which he operated, together with its restaurant and bar, from that date throughout the remainder of the period here involved. (R. 48.)

The books and records of the French Cafe, Southern Hotel and the Southern Bar were maintained on the cash basis of accounting under a single entry method of bookkeeping for decedent (R. 48) by Rose Goldstein Longway (hereinafter referred to as Rose Goldstein) from 1935 to August, 1947, when the Southern Hotel was demolished. Her services as bookkeeper for the French Cafe ceased on May 6, 1946, when decedent formed a partnership with Phil Bender. For her services, Rose Goldstein received \$10 per

month, one or two meals a day, and desk space in the lobby of the hotel where she conducted a business of her own realizing income from services rendered as a public stenographer and notary public, and from mimeographing, telephone answering, direct mail advertising, and income tax return preparation. (R. 49-50.)

Robert Webb, as manager of the Southern Hotel, was charged with the duty of hiring and supervising bellboys and maids, keeping order in the hotel, and acting as room clerk. He also, at all times material herein, had charge of the receipts of the French Cafe and Southern Bar although he had nothing to do with the conduct of these businesses. (R. 49.) For his services, Webb received \$100 per month plus room and board until 1945 when his salary was increased to \$45 a week. He also received illegal income in 1940 and 1941 in the form of commissions on bets on horse racing, using a telephone in the Southern Hotel for this operation. On some days he received as much as \$15 as his commission until his business was taken away from him against his will. (R. 49.)

Every morning during the years 1942 to May 6, 1946, when Webb reported to work, the steward or the cashier of the French Cafe would bring him a sheet containing figures showing the receipts for the preceding day, the cash register tape, and the cash receipts. The amount of daily receipts as shown on the cash register tape would be entered at the top of the sheet and from this amount there would be deducted "payouts" for the expenses of the day. Fol-

lowing instructions received by him from decedent, Webb would deduct and remove from the net receipts \$10 every day of the month and in addition thereto \$100, \$150, or \$200, on Saturdays, Sundays and holidays. (R. 51-52.)

The \$10 deducted by Webb each day from the net receipts of the French Cafe was under the decedent's instructions inserted in an envelope marked "French Cafe" which was kept in decedent's safe. At the end of the month the envelope would contain an amount ranging from \$280 to \$310 depending on the number of days in the month. Webb would then take the amount out of the envelope and give it to the decedent who would have it deposited in his personal bank account or put it in his safe deposit box at the Anglo California National Bank or would put it in his pocket. When the money was removed, the envelope would be destroyed, and Webb would start the next month with a new envelope. (R. 52.) The larger amounts deducted from cash receipts on Saturdays, Sundays and holidays were placed in another envelope marked "French Cafe" and on the outside of this envelope Webb would note the date of the deduction and the amount which decedent instructed Webb to deduct. (R. 52-53.)

At times, after deducting the usual \$10 or the larger amounts from the net receipts of the French Cafe, the resulting figure would be below \$300. Webb was instructed by decedent in such instances to make out a check, drawn upon the account of the French Cafe, payable to cash in an amount which, when added to the receipts as thus reduced would produce a figure

in excess of \$300. Although the addition of the amount of the check to the net receipts for the day increased the receipts and the deposit for that day by that amount, the increase was neutralized for tax purposes by the fact that the amount of the check was falsely entered on the check stub as an expenditure for supplies and was entered on decedent's books pursuant to instructions from decedent and Webb as such an expenditure by the bookkeeper for each of the years 1942, 1943, 1944, 1945, and up to May 6, 1946. (R. 53.)

The Southern Bar operated on two shifts. Webb would receive the cash receipts from the two shifts from the respective bartenders and would then total the cash receipts for the day and deduct the amount of "payouts" for expenses. The decedent instructed him to deduct and remove each day from the net receipts thus determined the amount of \$25. The \$25 daily withdrawals, beginning in 1942 and continuing until a short time before the Southern Bar was closed in August, 1947, were inserted in an envelope marked "Bar" which was placed in the safe. Decedent also instructed Webb to deduct an additional larger amount on Saturdays, Sundays and holidays and this practice was followed from October, 1942, to at least July, 1947. This amount varied between \$100 and \$200, depending on the size of the receipts, and were placed in the comparable envelope for similar deductions made on such days from the receipts of the French Cafe. (R. 54.) When Webb was absent, Rose Goldstein handled the receipts of the French Cafe and the Southern Bar. On these occasions, the

same deductions were taken from the daily and week-end receipts of the businesses as were taken by Webb when he was present. Decedent told her the amounts to be taken as deductions. (R. 54-55.)

Decedent had bank accounts in the Bank of America National Trust and Savings Association, Bakersfield, California, for the French Cafe, Southern Bar, and the Southern Hotel, and also a bank account for the French Cafe in the Anglo California National Bank, Bakersfield, California. He had a personal account and a safety deposit box at the Anglo Bank. Webb was authorized by the decedent to draw checks on the bank accounts of the French Cafe and Southern Bar and he drew checks on these accounts to meet payroll and other expenses. (R. 50.) Practically all of the deposits for all of the taxable years to the various bank accounts of decedent's businesses, including those to his personal bank account, were made by Webb in the form of cash and checks. Webb went to the bank every day, sometimes three or four times a day, to make deposits. The amounts deposited as the receipts of the French Cafe and the Southern Bar were entered daily during the years 1942 through 1947, in "year books", consisting of a diary-type volume for each year with a half page or page for each day of the year. (R. 51.) Decedent sometimes gave Webb cash and told him to convert the cash into thousand dollar bills. Decedent would put these bills in his safe deposit box at the Anglo Bank. On one occasion when Webb accompanied decedent to the bank, decedent had twenty \$1,000 bills when he returned from a visit to the box and bought \$20,000 worth of war bonds.

Decedent told Webb he made this purchase and Webb saw him make it. (R. 51.)

The receipts of the French Cafe and the Southern Bar were recorded daily by Webb and, in his absence, by Rose Goldstein in "year books" during the years 1942 through August 10, 1947. The year books did not reflect the actual receipts for the businesses during those years because of the daily understatements of income set forth *supra*. (R. 55.) In addition, the receipts that were recorded on the daily sheets of the French Cafe and in the year books were always reduced by amounts actually paid out in cash for supplies. (R. 56.) Upon instructions from the decedent, the cash journal of the French Cafe reflects cash purchases for the years 1943 in the amount of \$17,872.79, 1944 in the amount of \$24,140.70, 1945, in the amount of \$1,279.14, and 1946 in the amount of \$1,969.91, which had already been deducted from receipts on the daily sheets, resulting in a duplication and overstatement of cash purchases. Over and above the overstatement of purchases shown in the cash journal, decedent instructed Rose Goldstein to "boost" fictitious purchases on his individual income tax returns so that purchases for the French Cafe which are shown in the cash journal to be in the amounts of \$48,339.67 for 1943 (already overstated by \$17,872.79) and \$45,906.93 for 1944 (already overstated by \$24,140.70) are shown on the individual income tax returns of decedent in the amounts of \$66,791.12 for 1943 and \$55,944.92 for 1944. (R. 57, 59.)

The decedent's income tax return for 1943 shows an opening inventory for the French Cafe of \$3,500 and

a closing inventory of \$1,050, and an opening inventory for the Southern Bar of \$16,452.65 and a closing inventory of \$1,695. His income tax return for 1944 shows an opening inventory for the Southern Bar of \$1,695 and a closing inventory of \$3,050.62. Actual inventories were not kept for the French Cafe or for the Southern Bar for the years 1943 and 1944 and the books and records of the French Cafe and Southern Bar do not reflect that inventories were kept for those years. The inventory figures that were used by the bookkeeper to determine income were given to her by the decedent without any verification. (R. 58.)

Decedent habitually used alcoholic beverages and at times drank to excess. During the period August 24, 1942 to September 21, 1945, he visited a doctor at least six times and was treated for alcoholic neuritis, arthritis, thrombophlebitis and myocarditis. (R. 60.) In the latter part of 1945, decedent was confined to his rooms in the Southern Hotel for a period of three weeks under care of a practical nurse. At the end of the three-week period he had difficulty walking and was in a wheel chair for a short time. Webb was almost a daily visitor to decedent's room during the three-week period. (R. 60.) In 1946 decedent and his nurse moved from the hotel to a house which decedent had purchased. Thereafter, until he had a stroke in December of 1947, he visited the hotel practically every day for a short period of time. (R. 61.) At all times material herein, the decedent maintained a close inspection of the books and records of the French Cafe and the Southern Bar, checked on the daily receipts and payouts of these businesses, gave in-

structions as to daily and week-end withdrawals from the receipts of these businesses, made it a practice to know everything that was going on, and closely supervised the affairs of these businesses. During the years 1942 through 1946, and until he had a stroke in December, 1947, he was mentally alert and had a keen mind insofar as his businesses were concerned. (R. 61.)

Webb had a personal checking account in the Bank of America during the years 1942 through 1947, and maintained a safe deposit box in that bank where he kept cash. He never deposited any of the receipts from the French Cafe or the Southern Bar in his bank account. (R. 61-62.) Rose Goldstein's total deposits in her personal bank account, representing income derived from her business during the years 1943 through 1947 aggregated \$40,339.28. (R. 62-63.)

Decedent followed a consistent pattern of deliberately understating receipts of the French Cafe for 1942 to May 6, 1946, inclusive, and of the Southern Bar for 1942 to August 10, 1947, inclusive. He deliberately overstated purchases for the French Cafe in 1943, 1944 and 1945, despite repeated objections by his bookkeeper. (R. 64.) Decedent caused such books and records as were kept on his behalf to omit specific items of income for the years 1942 to 1947, inclusive, and to overstate specific items that reduced income for the years 1943, 1944 and 1945. He caused false entries to be made in his books and records for the years 1942 to 1947, inclusive. (R. 64.) Decedent filed false and fraudulent income tax returns for the taxable years 1942 to 1947, inclusive, and part of the

deficiencies for each of these years was due to fraud with intent to evade tax. (R. 64.)

The Tax Court found that the Commissioner's proof overwhelmingly established fraud and that the testimony of Robert Webb and Rose Goldstein was strong and convincing, and was in part corroborated by documentary evidence. (R. 64.) It further found that the specific items furnished a more accurate guide to the computation of decedent's net income than the net worth statement presented to the Court (R. 66) and that the Commissioner's adjustments (including those embodied in his amended answer) as to each item in controversy, with the exception of certain receipts from the Southern Bar for the year 1942, were strongly supported by the evidence (R. 65). The decision of the Tax Court pursuant to its prior findings of fact and opinion determined the following deficiencies and penalties against decedent for the taxable years involved (R. 88):

Year	Kind of Tax	Deficiency	Additions to Tax Sec. 293(b), I.R.C. 1939
1942.....	Income.....	\$5,901.47	\$2,778.22
1943.....	Income and Victory.....	52,913.50	33,454.19
1944.....	Income.....	53,725.33	28,728.08
1945.....	Income.....	46,292.81	23,146.41
1946.....	Income.....	12,303.72	6,151.86
1947.....	Income.....	17,214.11	8,607.06

SUMMARY OF ARGUMENT

The Commissioner of Internal Revenue determined deficiencies in income taxes against the decedent for the taxable years 1942 through 1947, inclusive, and further determined that decedent had filed false and fraudulent returns for these years with an intent to

evade tax. In making his determination of income for the entire period under review the Commissioner relied upon specific omissions from taxable income. Except for a minor portion of the deficiency for 1942, the deficiencies determined by the Commissioner were approved by the Tax Court. The findings of the Tax Court should be affirmed unless clearly erroneous.

Petitioner objects to the reliance by the Tax Court, in determining decedent's income, in part, upon the testimony of two of decedent's former employees. Instead, the petitioner asserts, the Commissioner should have relied upon a net worth statement, stipulated to by the parties, which disclosed a lesser tax liability. The Tax Court noted that the net worth statement itself shows substantial amounts of unreported income, although less than those determined by the Commissioner's specific adjustments, and, moreover, that there is no rule of law requiring the use of a net worth statement. It found that, on the record, the evidence as to specific items furnished a more accurate guide to the computation of decedent's net income than the net worth statement.

With respect to petitioner's objection that the testimony of the Commissioner's witnesses was unworthy of belief by virtue of the fact that they possibly diverted decedent's funds to themselves, the Tax Court found that the main thrust of their testimony was credible, consistent, powerful, and persuasive and that it had no doubt on the evidence that, pursuant to explicit instructions of the decedent, false and fraudulent returns were prepared which understated receipts and overstated purchases.

Decedent's returns in comparison with the determination made by the Commissioner as adjusted by the Tax Court, or, even in comparison with the net worth statement which petitioner urges should have been relied upon by the Commissioner, show a consistent pattern of under-reporting income in all the taxable years before this Court. Decedent specifically failed to report as income a pre-determined amount of receipts from the French Cafe and the Southern Bar, overstated his purchases for the French Cafe, omitted additional receipts from his businesses on weekends and holidays, and reported non-existent inventories on his tax returns. The Commissioner fully sustained his burden of proving that a part of the deficiency for each of the taxable years was due to fraud with intent to evade tax, thereby sustaining the 50 per cent addition to tax and lifting the bar of the statute of limitations as to the years 1942-1944.

The addition to tax pursuant to Section 293(b) of the Internal Revenue Code of 1939 for each of the years involved survives the death of the taxpayer.

ARGUMENT

I

The Tax Court, upon the record, was justified in upholding in principal part the Commissioner's determination of deficiencies in income tax for the taxable years involved

The Commissioner's determination of a deficiency is presumptively correct. *Helvering v. Nat. Grocery Co.*, 304 U.S. 282; *Helvering v. Taylor*, 293 U.S. 507; *Goe v. Commissioner*, 198 F. 2d 851 (C.A. 3d), certiorari denied, 344 U.S. 897; *Snell Isle, Inc. v. Com-*

missioner, 90 F. 2d 481 (C.A. 5th), certiorari denied, 302 U.S. 734. The burden of overcoming this presumption is upon the taxpayer. Here, the Tax Court concluded that the petitioner had failed to meet this burden except as to a minor portion of the 1942 deficiency.

It is a well accepted principle that the Tax Court's findings will not be disturbed upon review except when clearly erroneous; here, it is submitted, the record amply sustains them. The Tax Court based its conclusions in the instant matter in part upon its appraisal of the credibility of witnesses and their testimony and in part upon the records maintained on behalf of the decedent. It has long been established that upon review, due regard is given to the opportunity possessed by the trial court to appraise the credibility of witnesses. *United States v. Gypsum Co.*, 333 U.S. 364, rehearing denied, 333 U.S. 869; *Baumgardner v. Commissioner*, 251 F. 2d 311 (C.A. 9th); *National Brass Works v. Commissioner*, 205 F. 2d 104 (C.A. 9th); *Ferrando v. United States*, 245 F. 2d 582 (C.A. 9th); *Staudt v. Commissioner*, 216 F. 2d 610 (C.A. 4th); *Hague Estate v. Commissioner*, 132 F. 2d 775 (C.A. 2d), certiorari denied, 318 U.S. 787; Rule 52(a), Federal Rules of Civil Procedure; Section 7482(a) of the Internal Revenue Code of 1954 (Appendix, *infra*) (the successor to Section 1141(a) of the 1939 Code). In the light of the record before it, the Tax Court was fully justified in upholding in principal part the Commissioner's determination of deficiencies for the taxable years involved.

However, the petitioner now asserts in this Court that the testimony of decedent's former employees is not an acceptable basis for determining the income tax liabilities of the decedent. (Br. 14.) But this position of the petitioner is clearly without foundation.

The crux of Webb's and Goldstein's testimony relates to the control which decedent exercised over the conduct of his businesses. They testified that at all times material herein the decedent maintained a close inspection of the books and records of the French Cafe and the Southern Bar (R. 105-106, 503-504), checked on the daily receipts and payouts of these businesses (R. 105-106, 367-369, 376-377, 486-488), gave instructions as to the daily and week-end withdrawals from the receipts of these businesses (R. 110, 117-121, 144-145, 362-363, 443-448, 464, 482-485), made it a practice to know everything that was going on (R. 463-464), and closely supervised the affairs of these businesses. (R. 448-452, 538.) During the years 1942 through 1946, and until he had a stroke in December, 1947, he was mentally alert and had a keen mind insofar as his businesses were concerned. (R. 149-150, 463-465.)

The books and records of the businesses supplement the testimony of the witnesses. The entries in the year books, the cash journals, the checkbooks, and the daily sheets all disclose inconsistencies and understatements of income in the decedent's individual income tax returns. (R. 130-131, 440-462, Stip. B, Exs. D-I, M-V.) The petitioner cannot deny the existence of these inconsistencies and understatements. (R.

436, 529.) HE instead alleges that Webb and Goldstein possibly made these entries for the purpose of concealing a plan of embezzlement. (Br. 15.) If that were so, petitioner failed to offer any evidence whatsoever to substantiate ^{his} ~~its~~ allegation and we submit that there is no evidence in the record that Webb and Goldstein ever received any of the funds that were withheld from the receipts of the French Cafe or the Southern Bar. Moreover, what benefit would accrue to the would-be embezzlers by falsifying inventories on decedent's individual income tax returns for 1943 and 1944? These returns show opening and closing inventories for the French Cafe and Southern Bar although actual inventories were not kept for those businesses and their books and records do not reflect that inventories were kept for those years. (R. 502, 536-538, Exs. E-F.) Again, what benefit would Webb and Goldstein receive from duplicating cash purchases on decedent's returns? The cash journals for the French Cafe show amounts totaling \$17,872.79 for 1943, \$24,140.70 for 1944, \$1,279.14 for 1945, and \$1,969.91 for 1946, representing cash purchases of the French Cafe. These amounts were reflected in purchases when the income tax returns were prepared, even though they had already been subtracted from the receipts of the French Cafe for the years 1943-1946. (R. 448-452, 461-462, Exs. E-H, M, V.) Furthermore, decedent's income tax return for 1943 reports purchases for the French Cafe in the amount of \$66,791.12, although the cash journals disclose an already inflated sum of only \$48,339.67. (R. 440-442, Exs. E, O, U.) In 1944 the return reports purchases

of \$55,944.92 despite the cash journals' total, again inflated, of \$45,906.93. (R. 427-431, Exs. F, N, V.) Certainly Webb and Goldstein could realize no gain from these falsifications.

In its brief before this Court, the petitioner further seeks to discredit the Commissioner's witnesses, Webb and Rose Goldstein, by alleging the existence of inconsistencies in their testimony. For example, he attempts to confuse Webb's testimony with respect to the envelopes containing withdrawals of \$10 and \$25 per day with his testimony regarding the envelope containing larger amounts withheld on week-ends and holidays. (Br. 16-17.) However, the record clearly discloses the consistency of Webb's testimony. Decedent never touched the envelopes containing the \$10 and \$25 until the end of the month. (R. 128, 353-354.) At times, however, decedent would take money out of the envelope containing the *larger* amounts withheld on week-ends and holidays so that there would be no cash left at the end of the month. (R. 128-129, 193-197, 353-354.) Again, there is no inconsistency in Webb's testimony with regard to the writing of "French Cafe" on the envelope (R. 195-197), the times at which he picked up or received the receipts and the register tapes from the Southern Bar (R. 175-178), the mental condition of decedent (R. 149-150), and the falsification of the daily sheets from the French Cafe. (R. 110, 117-121, 144-147.)

Webb's testimony with regard to the issuance of checks clearly establishes that decedent instructed Webb to make checks out to cash which were added to the daily receipts of the French Cafe and to mark

the check stub "supplies". As a result, decedent increased the receipts for the day to make them look "respectable" while at the same time neutralizing the effect of additional income reflected in the receipts by deducting the amount, fictitiously spent on "supplies", from income. (R. 300, 434-438.)

Petitioner cites additional contradictions which it allegedly finds in Webb's and Goldstein's testimony. A reading of the record will disclose that these alleged contradictions do not exist, that in many instances the witnesses' testimony has been taken out of context or their replies were misinterpreted by counsel for petitioner. Furthermore, many conclusions drawn by petitioner from the testimony of the witnesses do not logically follow. For example, petitioner lays great stress upon the asserted fact that Webb was "very vague and indefinite" as to when he received the receipts from the French Cafe and the Southern Bar and what he did with them. (Br. 18, 26-27.) The record shows that Webb clearly set out the procedure followed in collecting receipts. (R. 174-177.) Petitioner interprets decedent's instructions to Webb to increase the daily receipts by adding to them a check payable to cash as increasing the bank balances. (Br. 20.) But as indicated above, the record makes it clear that this practice was neutralized for tax purposes by marking the check stubs to indicate that these amounts were expended for supplies. (R. 300, 434-438, Ex. T.)

Further, petitioner quotes Webb as testifying to decedent's health in contradictory terms. (Br. 23.) ~~HE~~ neglects, however, to point out the context in

which his replies were made. (R. 149-151, 183-184.) Nowhere in the record does it appear that decedent did not have complete use of his faculties, at least until December of 1947. None of petitioner's witnesses were able to rebut the direct testimony of Webb and Goldstein that decedent kept in daily touch with the affairs of his businesses either by personally coming downstairs to look over the books and records, during the earlier years, or having the records brought to him by Webb or being driven over to the hotel by his nurse during the later years. (R. 389, 410-411, 552-565.) There is no question about decedent's mental capacity in 1942 when the scheme to withhold receipts was set up and this scheme was used until August 1947 when the hotel was demolished.

II

The Commissioner was not bound to rely upon the net worth method in determining the income of decedent for each of the years under review but was entitled to determine decedent's income by the use of specific omissions from the income returned which were clearly established

Petitioner admits that there are deficiencies to the extent of the alleged increase in net worth during the taxable years and contends that in the determination of such deficiencies the Commissioner should have used the increase in net worth method rather than relying upon specific omissions from income. (Br. 9-11.)

Section 41 of the Internal Revenue Code of 1939 (Appendix, *infra*) provides generally that the determination of income shall be upon the basis of the method of accounting regularly employed in keeping

the books, but where the method employed does not clearly reflect income or where proper records are not kept or are lost "the computation shall be made in accordance with such method as *in the opinion of the Commissioner* does clearly reflect income." (Italics supplied.) The choice as to which method of computation of income shall be applied in a situation such as this, wherein no books are produced or inaccurate books have been kept, rests not with the petitioner but with the Commissioner. *Halle v. Commissioner*, 7 T.C. 245, 250, affirmed 175 F. 2d 500 (C.A. 2d), certiorari denied, 338 U.S. 949; *Miller v. Commissioner*, decided April 29, 1955 (1955 P-H T.C. Memorandum Decisions, par. 55,112), affirmed on this point, 237 F. 2d 830, 838 (C.A. 5th); *United Dressed Beef Co. v. Commissioner*, 23 T.C. 879, 885; *Funk v. Commissioner*, 29 T.C. 279, 293, affirmed *sub. nom.* *Furnish v. Commissioner*, 262 F. 2d 727 (C.A. 9th); *Schira v. Commissioner*, 240 F. 2d 672 (C.A. 6th); *Stone v. Commissioner*, 22 T.C. 893, 904. The same contention made by petitioner herein was raised in *Schellenbarg v. Commissioner*, 31 T.C. 1269. The Tax Court held as follows (p. 1277):

In a further effort to substantiate their position, petitioners claim that respondent failed to utilize an accepted method of reconstructing income pursuant to the authority granted him by section 41 of the 1939 Code. They maintain that at least four separate methods were open to him, all of which he chose to disregard, i.e., increases in net worth, analysis of bank deposits, percentage markup, and the personal

expenditures method. Section 41 of the Code provides, in the event the method of accounting utilized by the taxpayer does not clearly reflect income, that "the computation shall be in accordance with such method *as in the opinion of the Commissioner* does clearly reflect the income." (Italic supplied.) It is thus apparent that the choice as to the method of reconstruction to be employed lies with the Commissioner, and not the taxpayer, the only restriction being that the method adopted be reasonable.

The Tax Court found, and properly so, that on the present record the evidence as to specific items of understated income and overstated deductions furnishes a more accurate guide to the computation of decedent's net income than the net worth statement. (R. 66.) This is particularly so in view of the existence of a safety deposit box which decedent maintained at the Anglo Bank and in which he deposited cash and bonds in large sums. (R. 179, 190-192.) The petitioner's query as to where is the sum of \$131,000 (Br. 15), which reflects the difference between the understatement disclosed by the evidence relating to specific items and the understated income disclosed by the net worth statement, is readily answerable by reference to the safety deposit box whose contents are not included in the net worth computation. (Br. 41-42).

Petitioner obviously overlooks the fact that the net worth technique of computing income is not a method of accounting. It is no more than proof of income by circumstantial or indirect evidence. *Davis v. Commissioner*, 239 F. 2d 187, 188 (C.A. 7th); *Baum-*

gardner v. Commissioner, 251 F. 2d 311 (C.A. 9th). The Tax Court properly relied upon the testimony of the witnesses and the records and books presented in evidence to arrive at its determination of deficiencies in tax and additions to tax for fraud. The weighing of all the evidence concerning the disputed amount and the translating of it into an actual monetary figure is a proper judicial function well recognized by the courts. *Bodoglau v. Commissioner*, 230 F. 2d 336 (C.A. 7th); *Baumgardner v. Commissioner*, *supra*; *Commissioner v. Thompson*, 222 F. 2d 893 (C.A. 3d); *Cohan v. Commissioner*, 39 F. 2d 540 (C.A. 2d).

We submit that, under the conditions present herein, the Tax Court correctly relied upon the Commissioner's evidence disclosing specific items of understated income and overstated deductions rather than the limited disclosure of unreported income afforded by the net worth method.

III

The Commissioner fully sustained his burden of proving that a part of the deficiency for each of the taxable years was due to fraud with intent to evade tax, thereby sustaining the 50 percent addition to tax and lifting the bar of the statute of limitations as to the years 1942-1944²

The burden of proof of fraud rests upon the Commissioner. Section 7454(a) of the Internal Revenue Code of 1954 (Appendix, *infra*). In proving fraudulent intent the Commissioner has to show only that some part of each deficiency was due to fraud with intent to evade tax. Section 293(b) of the Internal

² No question as to limitations with respect to the remaining years is presently in issue.

Revenue Code of 1939 (Appendix, *infra*). As in the case of a factual determination such as the amount of the deficiency, it is a well accepted principle that a Court of Appeals will not disturb the Tax Court's findings as to fraud if they are supported by clear and convincing evidence. *Helvering v. Kehoe*, 309 U.S. 277; *Rose v. Commissioner*, 188 F. 2d 355 (C.A. 9th), certiorari denied, 342 U.S. 850, rehearing denied, 342 U.S. 889; *Goe v. Commissioner*, 198 F. 2d 851 (C.A. 3d), certiorari denied, 344 U.S. 897; *Halle v. Commissioner*, 175 F. 2d 500 (C.A. 2d), certiorari denied, 338 U.S. 949; *Greenfeld v. Commissioner*, 165 F. 2d 318 (C.A. 4th). It is respectfully submitted that the Tax Court's finding of fraud in this case is amply supported by clear and convincing evidence and should be sustained. In the deficiency notice issued by the Commissioner it was determined that the decedent had fraudulently understated income in his income tax returns for each of the taxable years named in the deficiency notice. (R. 9-11.) In the proceeding in the Tax Court, it was found that decedent followed a consistent pattern of deliberately understating receipts of the French Cafe for 1942 to May 6, 1946, inclusive, and of the Southern Bar for 1942 to August 10, 1947, inclusive; that he deliberately overstated purchases for the French Cafe in 1943, 1944, 1945, and 1946 despite repeated objections by his bookkeeper, that he caused such books and records as were kept on his behalf to omit specific items of income for the years 1942 to 1947, inclusive, and to overstate specific items that reduced income for the years 1943, 1944 and 1945; and that decedent caused

false entries to be made in his books and records for the years 1942 to 1947, inclusive. (R. 55-60; 64.)

A comparison of the net income reported by decedent on his tax returns, the net income stipulated to by petitioner under the net worth method, and the net income determined by the Commissioner, as adjusted by the Tax Court's findings and the computation under Tax Court Rule 50 (Appendix, *infra*) for the taxable years under review, is as follows (R. 12-18, 81-87, Pet. Br. 42.):

	Income Reported	Net Worth Stipulation	Income determined under Rule 50 of the Tax Court
1942	\$4, 121. 92	\$14, 587. 64	\$18, 886. 90
1943	17, 859. 24	46, 232. 20	104, 904. 18
1944	35, 493. 94	81, 547. 11	105, 491. 34
1945	44, 959. 76	102, 854. 84	100, 649. 59
1946	89, 060. 84	83, 102. 34	103, 918. 42
1947	27, 371. 48	30, 681. 27	53, 940. 57

It is obvious that there is a shocking disparity, not only between the net income reported by decedent in his tax returns and that determined by the Tax Court, but between the amount reported on the returns and the net income disclosed by the net worth statement stipulated to by the petitioner. A persistent failure to report large amounts of income over an extended period without more is strong evidence of fraudulent intent. *Holland v. United States*, 348 U.S. 121; *Smith v. United States*, 348 U.S. 147; *Furnish v. Commissioner*, 262 F. 2d 727, 728-729 (C.A. 9th); *Anderson v. Commissioner*, 250 F. 2d 242, 249-250 (C.A. 5th); *Lipsitz v. Commissioner*, 220 F. 2d 871 (C.A. 4th). Where, as here, the pattern of unrecorded and unreported income is accompanied

by specific evidence of fraud, the requisite intent to evade tax is unmistakably clear.

In the instant case the evidence of fraud permeates the record. Decedent specifically instructed Webb and Rose Goldstein to withhold \$10 and \$25 per day from the receipts of the French Cafe and the Southern Bar, respectively. He instructed them to deduct additional amounts of \$100, \$150 and \$200 from the businesses on week-ends and holidays. (R. 110, 117-121, 144-147, 362-363, 443-448, 464, 482-485.)³ He instructed his bookkeeper to duplicate purchases and to set up false inventory records. (R. 430, 435-436, 536-538.) During all the years involved herein, decedent maintained a close inspection of the books and records of the French Cafe and the Southern Bar (R. 105-106, 503-504), checked on the daily receipts and payouts of these businesses (R. 105-106, 367-369, 376-377, 486-488), made it a practice to know everything that was going on, and closely supervised the affairs of these businesses. (R. 448-452, 463-464, 538.) During the years 1942 through 1946 and until he had a stroke in December, 1947, he was mentally alert and had a keen mind insofar as his businesses were concerned. (R. 149-150, 463-465.)

The petitioner also contends that to find that the

³As the Tax Court noted in its opinion (R. 65 and fn. 2), the evidence would support adjustments of unreported income in excess of those determined by the Commissioner. This is so because the Commissioner restored to income \$100 for each of the 104 Saturdays, Sundays and holidays in the pertinent years. He would have been justified in adding a further amount for those days in which more than \$100 was withheld.

deceased fraudulently attempted to evade income taxes would be tantamount to finding him guilty of a serious offense in a hearing not far removed from one in the nature of an *ex parte* proceeding. (Br. 36-37.) He asserts that the fact that the administrator of the estate opposed the claim and exercised his right of cross-examination is of little comfort under such circumstances when decedent is not present to refute the testimony presented against him. In effect, petitioner is contending that fraud can never be fairly proven against a taxpayer where he has no opportunity directly to refute the evidence of fraud. This argument was presented by a decedent's estate in *Lee v. Commissioner*, 227 F. 2d 181 (C.A. 5th). The court there held as follows (p. 184):

* * * though we agree with appellant that the inability of the taxpayer to confute or explain what unconfuted and unexplained has damaging weight, has to that extent increased the factual difficulties of the taxpayer and lessened those of the Commissioner, we are bound to hold that this consideration fully expends itself when giving it all the proper weight it is entitled to, we still cannot say, as we cannot here, that on the examination of the evidence as a whole we are left with the firm conviction that the findings were wrong and must be set aside.

We submit that on an examination of the evidence as a whole herein, it cannot be said that the Tax Court findings were wrong even after giving weight to petitioner's contention that decedent's absence hampered his case.

IV

The addition to tax pursuant to section 293(b) of the Internal Revenue Code of 1939 for each of the years involved survives the death of the taxpayer

The Tax Court in its opinion notes that the petitioner raised the issue of the survival of the fraud penalty imposed subsequent to the death of the taxpayer in its brief. No such issue was raised in the pleadings; therefore the court did not consider the issue to have been properly before it. (R. 68.) We respectfully submit that this issue, by virtue of petitioner's failure to raise it in his pleadings, is not properly before this court on appeal.

However, aside from the propriety of petitioner's contention at this date, the law is clear that unpaid federal taxes, including the 50 per cent addition to tax for fraud, do not abate upon the death of the taxpayer and they remain collectible from the assets of the taxpayer's estate. *Lee v. Commissioner*, 227 F. 2d 181, 183 (C.A. 5th); *Scadron's Estate v. Commissioner*, 212 F. 2d 188 (C.A. 2d), certiorari denied 348 U.S. 832; *Reimer's Estate v. Commissioner*, 12 T.C. 913, affirmed *per curiam*, 180 F. 2d 159 (C.A. 6th); *Briden's Estate v. Commissioner*, 11 T.C. 1095, 1135-1136, affirmed *sub. nom. Kirk v. Commissioner*, 179 F. 2d 619 (C.A. 1st); G.C.M. 22326, 1940-2 Cum. Bull. 159. The Tax Court in *Reimer's Estate v. Commissioner*, *supra*, in commenting on the history of Section

293(b) of the 1939 Code noted that in 1940 the Commissioner, relying upon the Supreme Court's decision in *Helvering v. Mitchell*, 303 U.S. 391, reversed his former position and held that the 50 per cent addition to tax for fraud does not abate upon the death of the taxpayer but is collectible from his estate. See G.C.M. 22326, 1940-2 Cum. Bull. 159. The Supreme Court had held in *Mitchell* that the assessment was not a criminal penalty and that, furthermore, it was not to be considered penal in any sense but rather a safeguard for the protection of the revenue and was intended to reimburse the Government for the heavy expense of investigation and the loss resulting from the taxpayer's fraud. Since the addition to tax is civil in nature, the Tax Court held that the remedy afforded the Government by the statute did not abate. This view was also taken by the Court of Appeals for the First Circuit in *Kirk v. Commissioner*, 179 F. 2d 619, 621, and was held to be the correct interpretation of the law by the Court of Appeals for the Second Circuit in *Scadron's Estate v. Commissioner, supra*.

The petitioner concedes (Br. 7-8) that the cases subsequent to *Briden's Estate v. Commissioner, supra*, have, in reliance upon *Helvering v. Mitchell, supra*, resolved this issue against the taxpayer. We submit that the petitioner's contention that the addition to tax on account of fraud abates upon the death of the taxpayer has no basis in law.

CONCLUSION

For the foregoing reasons, we submit that the decision of the Tax Court is correct and should be affirmed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1939:

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 276. SAME—EXCEPTIONS.

(a) *False Return or No Return.*—In the case of a false or fraudulent return with intent to evade tax or of a failure to file a return the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

* * * * *

(26 U.S.C. 1952 ed., Sec. 276.)

SEC. 293. ADDITIONS TO THE TAX IN CASE OF DEFICIENCY.

* * * * *

(b) *Fraud*.—If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be as assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in section 3612(d) (2).

(26 U.S.C. 1952 ed., Sec. 293.)

Internal Revenue Code of 1954:

SEC. 7454. BURDEN OF PROOF IN FRAUD AND TRANSFEREE CASES.

(a) *Fraud*.—In any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Secretary or his delegate.

* * * * *

(26 U.S.C. 1958 ed., Sec. 7454.)

SEC. 7482. COURTS OF REVIEW.

(a) *Jurisdiction*.—The United States Courts of Appeals shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of Title 28 of the United States Code.

* * * * *

(26 U.S.C. 1958 ed., Sec. 7482.)

Rules of Practice Before the Tax Court of the United States (Rev. to April 1, 1958):

RULE 50. COMPUTATIONS BY PARTIES FOR ENTRY OF
DECISION

(a) *Agreed computations.*—Where the Court has promulgated or entered its opinion determining the issues in a case, it may withhold entry of its decision for the purpose of permitting the parties to submit computations pursuant to the Court's determination of the issues, showing the correct amount of the deficiency or overpayment to be entered as the decision. If the parties are in agreement as to the amount of the deficiency or overpayment to be entered as the decision pursuant to the report of the Court, they or either of them shall file promptly with the Court an original and 2 copies of a computation showing the amount of the deficiency or overpayment and that there is no disagreement that the figures shown are in accordance with the report of the Court. The Court will then enter its decision.

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